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IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

NO. 798

FRANK M. TACK and LOIS V. TACK, Now THOMPSON, Life Tenants, and HARRY S. TACK, A Contingent Remainderman, Petitioners

v.

MELLON NATIONAL BANK AND TRUST COMPANY, Trustee of the Estate of FLORENCE TACK NORVELL, Deceased, and ROBERT B. McKINLEY, Guardian and Trustee Ad Litem, Sur Account Entitled Fifth Account of said Trustee, Respondents.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF PENNSYLVANIA

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RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

I. The Petition Should Be Dismissed for Lack of Jurisdiction.

A. *There is no federal or constitutional issue involved.*

Petitioners state, on page 28 of their printed Petition for Writ of Certiorari, that they accept the decision of the Pennsylvania Supreme Court in Catherwood Trust, 405 Pa. 61 (1961) that the 1947 Principal and Income Act here involved is applicable to trusts created before the date thereof, but they "do not accept the theory of the so-called 'time Table' of that decision that the rights of parties litigant are to be determined as of a

date upon which some Court passes upon the questions involved in the litigation rather than as of the date upon which the claimed rights of the parties actually arose." Petitioners do not make any statement as to when their claimed rights are deemed to have arisen. If their rights are deemed to be vested when the testamentary trust took effect upon the testator's death, and if they concede that the 1947 Principal and Income Act is applicable thereto, then there is no constitutional issue here presented. If their rights are deemed to have arisen when the dividends here involved were declared or earned, which admittedly was long after the 1947 Act went into effect, then there is no constitutional issue here presented. Therefore, if the only objection of the Petitioners to the Catherwood decision (which the Pennsylvania Supreme Court followed and applied in this case) is the "Time Table" thereof, and not the constitutionality of its holding on the issue of retroactivity, the Petitioners have not presented any constitutional issue for determination by your Honorable Court.

B. *There are no conflicting decisions to be reconciled by your Honorable Court.*

The Pennsylvania Supreme Court has decided the matter in conformity with the clear pronouncements of your Honorable Court and the majority rule now in force, either by judicial decision or legislation, in most states, as more fully appears in part II hereof.

C. *The matter is one of state law on which the state court interpretation is final.*

The Pennsylvania legislature concededly had jurisdiction to decide what is or is not principal; sections 3 and 5 of the Principal and Income Act represent a proper exercise of that jurisdiction and the interpretation thereof is strictly a matter of state concern.

II. The Petition Should Be Dismissed for Lack of Merit.

A. *The State Court decision was in conformity with pronouncements of your Honorable Court and the rule in force in a majority of states.*

The Pennsylvania Legislature, in enacting Sections 3 and 5 of the 1947 Principal and Income Act, created no mere presumption but made a definite pronouncement and classification as to what dividends shall constitute principal. There is no question but that it was within the jurisdiction of the Pennsylvania Legislature to make such a determination; in the exercise of its wisdom it provided that stock dividends of the same kind and rank as that on which issued shall be deemed principal. This determination rested on the very nature and characteristics of such dividends as in fact being principal, and was in complete accord with the pronouncements of your Honorable Court. In *Towne v. Eisner,* 245 U.S. 418, 38 S.Ct. 158 your Honorable Court concluded that the stock dividend in question could not be reached by the Income Tax Act even though Congress had expressly declared it to be taxable as income. Your Court reasoned as follows:

> "Notwithstanding the thoughtful discussion that the case received below *we cannot doubt that the dividend was capital as well for the purposes of the Income Tax Law as for distribution between tenant for life and remaindermen.* What was said by this court upon the latter question is equally true for the former. 'A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased * * *' The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones" (emphasis supplied).

That decision was followed and applied by your Honorable Court in *Eisner v. Macomber,* 252 U.S. 189, 40 S.Ct. 109, wherein your Court again concluded, after another exhaustive study of the nature of stock dividends, that such dividends could not be taxed by Congress as "income" either under the Sixteenth Amendment "or otherwise". It is respectfully submitted, therefore, that if such dividend cannot be considered income for tax purposes, there is no reason for holding it to be income for distribution purposes, *the trust agreement not providing otherwise.* Thus, the Petitioners cannot successfully contend that they have been deprived of property without due process of law because what they in fact claim as income was properly determined to be principal.

In *People ex rel. Clark v. Gilchrist*, 243 N.Y. 173, 153 N.E. 39, Justice Cardozo stated that shares issued as a dividend "in their intrinsic nature are merely readjustments of the corpus" and "while in the hands of the fiduciary, were not gains or income 'of the trust' " and could not become income merely by distribution to the life tenant under the express terms of the trust.

In 1926 New York adopted as part of its Personal Property Law (Cons. Laws, ch. 41, sec. 17-a) a provision similar to sections 3 and 5 of the Principal and Income Act here involved. In *Matter of Ryan's Estate*, 294 N.Y. 85, 60 N.E. 2d 817, the lower court held that the stock dividend was allocable to income because it was an ordinary stock dividend paid out of corporate earnings derived during the period of the trust. On appeal, the Court of Appeals reversed, stating that by said Section 17-a the legislature provided that "*any* dividend which shall be payable in the stock of the corporation . . . shall be principal. . ." and therefore the court was not to determine whether the dividend in question was ordinary or extraordinary. The Court there emphasized that "In plain language the Legislature provided that 'any dividend which shall be payable in the stock of the corporation . . . shall be principal . . .' "

Justice Cardozo commented on said Section 17-a in his decision in *People ex rel. Clark v. Gilchrist*, supra, as follows:

> "The same Legislature that excluded stock dividends from the category of income for the purpose of taxation, went farther and amended the Personal Property Law (Cons. Laws, ch. 41) by enacting that under any will or deed hereafter made, unless

> otherwise therein provided, stock dividends shall be principal and not income of a trust * * * If stock dividends are still taxable as income to the extent that they belong to life tenant or beneficiary, the State may contest the propriety of the apportionment between life estate and remainder. So to read the statute is to misread it. In effect, the Legislature has said that stock dividends in their intrinsic nature are merely readjustments of the corpus."

And in *Equitable Trust Co. v. Prentice,* 250 N.Y. 1, 164 N.E. 723, Justice Cardozo again had occasion to note the nature and effect of a stock dividend as part of principal not only for tax purposes but also "for the purpose of another statute", to-wit, section 17-a of the New York Personal Property Law above discussed.

> "*Stock dividends in the true sense—i.e., dividends capitalizing surplus, as distinguished from those payable in the stock of a subsidiary* (People *ex rel.* Clark v. Gilchrist, 243 N.Y. 173, 178, 153 N. E. 39; U(nited) S(tates) v. Phellis, 254 U. S. 156, 42 S. Ct. 63, 66 L. Ed. 180—*have predominantly the quality of an increment to principal, though at times, in furtherance of intention, they have been classified as income.* When a dividend is paid in cash, the ownership of the corporate assets is changed; the Company owns less, and the shareholder owns more, or something essentially different, though its value be no greater. Upon the distribution of a stock dividend, ownership of the assets is precisely as it was. 'A stock dividend does not distribute property, but simply dilutes the shares as they existed before.' Note the similarity in reasoning with the decision

of your Honorable Court in Flaccus Estate, *supra.* Williams v. Western Union Tel. Co., 93 N. Y. 162, 189. Whatever gain results to the shareholder from the division of his certificates is indirect and incidental, not extracted from the assets like the recurrent yield of an investment. Lynch v. Hornby, *supra,* 247 U. S. 339, p(age) 344 (38 S. Ct. 543) (62 L. Ed. 1149); T. R. Powell, 'Income from Corporate Dividends,' 35 Harv. L. Rev. 363, 366, 367; Warren, 'Stock Dividends,' 33 Harv. L. Rev. 885. *The law is now established, in this court as elsewhere, that for the purpose of taxation such a dividend is capital, whether the shareholder takes it in his own right or for the benefit of another.* People *ex rel.* Clark v. Gilchrist, *supra. There should be cogent evidence of intention to justify us in holding that for the purpose of another statute it is to be ranked as something else."* (Emphasis supplied).

Sections 3 and 5 of the 1947 Principal and Income Act here at issue embody the Massachusetts rule which has long been in effect in other states. The progress and steady increase in the adoption of the Massachusetts rule was clearly pointed out in *In re Bank of New York & Fifth Avenue Bank,* 105 N.Y.S. 2d 211:

"The trust instrument here, in its form, structure and substance, indicates that it was drawn by an experienced expert draftsman. That it was written with Section 17-A in mind is clearly indicated by the provisions of Article Fifth. *The change effected by the enactment of that Section is so well stated In Re Strong's Will, 198 Misc. 7, 96 N. Y. S. 2d 75, 83, by Surrogate Witmer, that we adopt and quote it*

here. 'In the Osborne case the court noted the difference between the Massachusetts Rule and the Pennsylvania Rule with reference to stock dividends, and substantially adopted the Pennsylvania Rule.' As above noted, in 1926 our Legislature enacted section 17-A, as amended, of the Personal Property Law, thus establishing the Massachusetts Rule in New York as to trusts created thereafter. In 1935 the American Law Institute adopted the Pennsylvania Rule in its Restatement of the law of Trusts, Section 236. In 1948, however, the Institute reconsidered this question, found that the trend among the states, by decision and statute, is now to follow the Massachusetts Rule, and that the latter is in general more satisfactory, and amended section 236 of the Restatement of the Law of Trusts to accord with the Massachusetts Rule. Restatement of the Law, 1948, Supplement, Trusts, Section 236; and see Matter of Heinrich's Will, 195 Misc. 803, 811, 90 N. Y. S. 2d, 875, 883. Moreover, ever since the decision in the Osborne case our courts have recognized the difficulties of application of the principle therein adopted, and have figuratively sighed with relief at the realization that trusts created since the statute of 1926 are not governed by said decision. People ex rel. Clark v. Gilchrist, 243 N. Y. 173, 182, 153 N. E. 39, 41; Matter of Hagen('s Will), 262 N. Y. 301, 305, 186 N. E. 792, 793, supra. From this review of the progress of the law with respect to stock dividends it is evident that the attitude of our Legislature, of our courts and of the American Law Institute neither calls for nor permits an extension of the principle of the Osborne Case." (emphasis supplied).

Thus, it can be seen that the rule allocating to principal dividends of the same kind and rank as that on which issued is not a new rule arbitrarily made without logical basis. It is a rule based on the true nature and effect of such a stock dividend, as reasoned, studied and held by your Honorable Court. It is the Massachusetts rule adopted and followed by many states (See decision of the Pennsylvania Supreme Court, page 41 of Appendix to printed Petition for Writ of Certiorari). As stated in *Catherwood Trust,* 405 Pa. 61, as early as 1927 the rule was then followed "by Connecticut, Georgia, Illincis, Maine, North Carolina, Rhode Island, West Virginia, and the U. S. Supreme Court. See 24 A.L.R. 29. It was also the English rule."

It is the rule adopted and followed by the American Law Institute in its Restatement of the Law of Trusts; It is the rule adopted by the National Conference of Commissioners on Uniform State Laws in the drafting of the Uniform Principal and Income Act, who, in their Prefatory Note to the Act stated "the majority of the large commercial states have already favored the former and more convenient rule (the Massachusetts rule)...".

B. *Changes found necessary in future apportionment of income and principal under existing trusts are properly a matter for state legislature and state court determination, as your Honorable Court held in Demorest v. City Bank Co., 321 U.S. 36, 64 U.S. 384.*

The prior Pennsylvania rule of apportionment was abandoned not for the mere sake of expediency, but because that rule was so fraught with complexities that it was almost impossible to secure an equitable determination of what was or was not principal or income. As stated by the drafters of the Uniform Principal and Income Act:

> "Experience has shown that, however praiseworthy the intent, the latter Pennsylvania Rule is unworkable, since neither trustee nor the Court has the means to value the corporate assets in such way as to secure the fair adjustment aimed at."

In *Catherwood Trust,* 405 Pa. 61, the Pennsylvania Supreme Court noted at length the complexities of the Pennsylvania rule of apportionment especially when applied to modern day corporate financing and record-keeping, the Court there stating:

> "* * * In recent years the ingenuity of corporate management, seeking to achieve various ends such as broadening or enhancing the market for its stock, effect tax savings, etc., has produced a complexity of corporate transactions which involve the transfer on corporate books of earnings, earned surplus, etc., from one account to another. Earnings, under

modern corporate practice, no longer retain the simplicity of meaning of the earnings considered by this Court in Earp's Appeal, *supra,* and other decisions!"

Your Honorable Court in *Demorest v. City Bank Co.,* 321 U.S. 36, 64 S. Ct. 384, upheld changes by the New York State Legislature in the apportionment of proceeds from salvage operations of mortgaged properties acquired by a trustee. The remaindermen under existing trusts there claimed that the new statutory rule of apportionment under 17-c of the New York Personal Property Law, being less favorable to them than the rules theretofore existing, was violative of the Fourteenth Amendment because it deprived them of rights secured to them under the prior rule of apportionment. Your Honorable Court did not agree with that contention but affirmed the constitutionality of such retroactive change in the apportionment of the proceeds from salvage operations. The New York legislature in enacting said section 17-c expressly stated that its purpose was "the simplification of the rules of procedure in mortgage salvage operations and the elimination of present complications which work to the disadvantage of the life tenant, . . . Such fixed right is granted in lieu of the discretion now given to the trustee to pay net income or any part thereof to the life tenant."

Thus, the New York legislature substituted a definite rule of apportionment for an apportionment within the Trustee's discretion. It thus took away from the beneficiaries the right to question the propriety of the distribution, just as the legislature did in this case. Your Honorable Court upheld such substitution, stating:

"The Chapal decision was rendered in response to a trustee's petition for instructions. But while such decisions were useful as precedents, they were felt not adequate to protect trustees against the hazards of litigation in particular cases, and the avowed effort of the court to adapt the law to the situation resulting from the depression, failed in practice. Hence the legislature intervened, adopted a rule which the trustee might have applied before, in its discretion, and prescribed it as a definite standard for setting apart income, protecting trustees against liability to remaindermen if they followed it. What appears really to have been taken from the remainderman is his right to question the equity of the rule in his individual circumstances, a right which he had while it was a rule of the court . . . The legislature has furthered certainty at cost of flexibility.

"Constitutional validity of this legislation if it had been made applicable to estates of decedents dying after its enactment is not questioned. It is objected only that application to an estate whose administration began before the Act so as to take away the remainderman's right to judicial examination of the trustee's computation of income makes it void for retroactivity.

". . . The case comes to this: Appellants took remainders at a time when the rules by which to sequester their interests in proceeds from complicated operations to salvage property were so indefinite that several years later the Court made an effort to devise more definitive rules for the purpose. They

were but partly successful, and a few years later the legislature made further and perhaps more authoritative and final rules. Comparing the later with the earlier effort, the remainderman in these particular cases finds himself prejudiced. He says we must confirm him in the earlier by striking down the later of two retroactive rules of law.

"This statute does not purport to open accountings already closed or to take away rights or remainders judicially settled under the old rule. The statute is applied only to judicial settlements pending at or instituted after its enactment. Rights to succession by will are created by the state and may be limited, conditioned, or abolished by it. *Irving Trust Co. v. Day,* 314 U.S. 556. The whole cluster of vexatious problems arising from uses and trusts, mortmain, the rule against perpetuities, and testamentary directions for accumulations or for suspensions of the power of alienation, is one whose history admonishes against unnecessary rigidity. The state may extend the testamentary privilege on terms which permit tying up of property in trust for possibly long periods. But the state on creation of such a trust does not lose power to devise new and reasonable directions to the trustee to meet new conditions arising during its administration such as the depression presented to trusts holding mortgages. Cf. *Home Building & Loan Assn. v. Blaisdell,* 290 U.S. 398. Nothing in the Federal Constitution would warrant us in holding that judicial rules tentatively put forward and leaving much to discretion will deprive the legislature of power to make further reasonable rules which in its opinion will expedite and

make more equitable the distribution of millions of dollars of property locked in testamentary trusts, even if they do affect the values of various interests and expectancies under the trust. The Fourteenth Amendment does not invalidate the Act in question."

It is to be noted that in a separate opinion Justice Douglas, with whom Justice Black concurred, stated:

"That is a question of New York law on which the New York court has the final say. It is none of our business—whether we deem that interpretation to be reasonable or unreasonable, sound or erroneous. *Sauer v. New York,* 206 U. S. 536 545-548. And there is no suggestion here that state law has been manipulated in evasion of a federal constitutional right. *Fox River Paper Co. v. Railroad Commission,* 274 U. S. 651, 657; *Broad River Power Co. v. South Carolina,* 281 U. S. 537, 540. Consequently I can see no possible claim to substantiality of any federal question, whatever view may be taken of the due process clause. I would therefore dismiss the appeal."

C. *The three decisions of Your Honorable Court relied on by Petitioners are clearly distinguishable.*

The Petitioners rely heavily and almost entirely on three decisions of your Honorable Court: *Schlesinger v. Wisconsin,* 270 U.S. 230, 46 S. Ct. 260; *Hoeper v. Tax Commission,* 284 U.S. 206, 52 S. Ct. 120 and *Heiner v. Donnan,* 285 U.S. 312, 52 S. Ct. 358. Each one of those cases is clearly distinguishable from the one at bar.

In *Schlesinger v. Wisconsin,* 270 U.S. 230, 46 S. Ct. 260, your Honorable Court determined that the statute there involved provided for an *arbitrary* classification between transactions which were taxable and similar transactions which were not taxable. Your Honorable Court noted the arbitrary nature of the classification as follows:

> "Gifts inter vivos within six years of death, but in fact made without contemplation thereof, are first conclusively presumed to have been so made without regard to actualities, while like gifts at other times are not thus treated. There is no adequate basis for this distinction . . ."
>
> "A classification for purpose of taxation must rest on some reasonable distinction."

In this case now before your Court the apportionment made in Sections 3 and 5 of the Pennsylvania Principal and Income Act of 1947 is based on a reasonable distinction between what constitutes principal and what constitutes income and reasonably classifies a stock dividend of the same kind and rank as that on which it is issued as principal, as already discussed herein.

In *Hoeper v. Tax Commission*, 284 U.S. 206, 52 S. Ct., 120 the state statute there involved attempted to tax as the husband's income, income which was in actual fact income of the wife, which statute on its face was thus violative of the Fourteenth Amendment. There was no reasonable justification whatever for such taxation. In the instant case, there was, as before discussed, a reasonable classification as principal of stock dividends of the same kind and rank as that on which issued; this was not a determination made by the legislature without regard to actualities; it was a classification based on the true nature and characteristics of such dividends, as already expressed by your Honorable Court in its decisions hereinbefore set forth; it was a classification which the legislature had the authority to make. There just is no comparison between the statute here involved and that involved in the Hoeper case.

Nor is the decision of your Honorable Court in *Heiner v. Donnan, et al.*, 285 U.S. 312, 52 S. Ct. 358, in any way relevant or governing. Congress there sought to tax every gift made within two years prior to death, such gift to be deemed to have been made in contemplation of death. Thus, Congress, was attempting to levy a tax on a mere assumption of a factual situation without any reasonable basis in fact for such assumption. Unless the transaction was in fact testamentary, it had no jurisdiction to tax; it could not give itself jurisdiction to tax by an assumption of a fact having no basis in reason. In the case now before your Court, the jurisdiction of the Pennsylvania legislature in the matter was not in any way dependent upon an assumed set of facts; the legislature admittedly had jurisdiction to determine, in the exercise of its wisdom what is or is not principal or

income. It exercised its jurisdiction properly, having made a reasonable classification based on the true nature and characteristics of the stock dividends here involved.

Petitioners repeatedly state, as they did before the Pennsylvania Supreme Court, that to hold the stock dividends here in question as principal is to go "contrary to the actual facts" and that "under the facts shown in the record below" to hold the stock dividends here in question as principal is unconstitutional. However, the Petitioner does not (and did not in the court below though such omission was remarked upon by Respondent) set forth just what "facts" it has reference to. Their failure to recite such facts upon which they thus place great reliance militates against the strength of their contention. But even if it were to be assumed, for purposes of argument, that Petitioners are arguing that the stock dividends here involved were the result of accumulated undistributed earnings being retained or reinvested by the company, there still would be no violation of any vested rights of the life tenant. As stated by the Pennsylvania Supreme Court in Catherwood, supra:

> "It does not follow, however, that these life tenants have any vested interest in the accumulated unpaid earnings of a corporation, the stock of which is held in the trust *or a vested interest in any particular apportionment formula for the ascertainment of such earnings* * * * (italics ours). It would be just as logical to reason that the life beneficiary of a trust has a vested interest in the particular accounting procedure employed by a corporation at the date that one or more of its shares become a part of the trust corpus as to reason that the life beneficiary has

a vested interest in a particular apportionment formula to ascertain the accumulated earnings of the corporation" (Emphasis supplied).

* * *

"The claimed vested interests of these life tenants is somewhat akin to the claimed vested interests in Com. *ex rel. Fortney v. Bartol,* 342 Pa. 172, 20 A.2d 313.* * * This Court said: 'The budgetary appropriations did not create in (the fire companies) a vested right in any fund.' *No more does an allocation of accummulated unpaid earnings by a corporation to an earned surplus or other account give these life tenants any vested right in such earnings"* (Emphasis supplied).

"Such rights these life tenants have in the income from this trust *but they have no rights to accumulated unpaid earnings of a corporation, nor to any particular mode or method of ascertaining what is or is not income. To hold otherwise would produce absurd results"* (Emphasis supplied).

CONCLUSION

It is respectfully submitted that the Petition for a Writ of Certiorari should not be granted.

Respectfully submitted,

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